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INFO RUEATRS/DEPT OF TREASURY WASHDC

UNCLAS JAKARTA 013480

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DEPT FOR EAP/MTS, EB/OIA, AND OBO/PD/PMB/CPB
DEPT PASS OPIC FOR SIMON/PITNEY

E.O. 12958: NA
TAGS: EFIN PREL KCOR ID
SUBJECT: FINANCE MINISTER ON OPIC, TAX ISSUES, AND NEC

¶1. (SBU) Finance Minister Sri Mulyani Indrawati told the Ambassador on December 14 that the Directorate General of Taxation (DG Tax) would need to finalize a review of Indonesia's international tax agreements before moving forward on an Overseas Private Investment Corporation (OPIC) Investment Support Agreement. She anticipated this would be completed by the end of December 2006. The same review should help the Government of Indonesia (GOI) resolve tax questions surrounding USAID's Aceh road project. Mulyani also said determining a price for two parcels of land currently occupied by the Embassy should be "straightforward," but that the actual transfer of the property could need to follow an elaborate new regulation. The Ambassador emphasized the unacceptability of U.S. foreign assistance projects being subject to multi-million dollar Indonesian tax bills. End Summary.

Moving Forward on an OPIC Agreement

¶2. (SBU) The Ambassador said the U.S. is puzzled about how to proceed on the draft OPIC Investment Support Agreement (ISA). The U.S. had worked hard since July 2006 on the agreement, and had thought that reaching a deal by the President's November 20 visit would be excellent publicity for Indonesia's efforts to attract investment. But in the end, we had made very little progress, the Ambassador noted, and we are no longer sure if Indonesia wants a new agreement. We are looking for your guidance, the Ambassador told the Minister. It would be helpful if Indonesia could appoint a lead negotiator with authority to negotiate.

¶3. (SBU) Mulyani's response focused on the tax exempt provisions of the ISA, and their relation to Indonesia's tax law and international tax agreements. She said the ISA is an "ad hoc" initiative, and said the U.S. position that OPIC had long operated on a tax-exempt basis, and should continue to do so, is "fair enough." However, before moving forward on the ISA, she added that she had asked the DG Tax to review Indonesia's international tax treaties and "tax free arrangements," some of which appear not to be based on Indonesian law or a "basic understanding of what Indonesia wants." As part of this process, DG Tax is also reviewing the Japan-Indonesia tax treaty. Mulyani said the Ministry of Finance (MOF) also wants to discuss how to treat the revenue of companies operating across international borders with Parliament. (Note: She did not distinguish between private companies and the USG-owned OPIC.)

¶4. (SBU) Mulyani continued that DG Tax has established a unit to conduct the review, but that it is staffed at too low a level. She said she had held a meeting yesterday with the Echelon I officials at MOF, and had instructed DG Tax to add more senior staff to the unit and to finish a report by the end of 2006. Mulyani added that she hopes to have a meeting this year with DG Tax staff to discuss the results of the review. An additional factor is the ongoing discussion in Parliament of draft laws on tax procedures, income taxes, and value added taxes. This may also result in changes to

the Government's assessment of Indonesia's international tax agreements. Mulyani concluded by noting that the Government is aware of the importance of reaching a new ISA, and wants to settle the matter as quickly as possible.

USAID Partners Face Growing Tax Problems

¶5. (SBU) Following up on Mulyani's discussion of tax issues, the Ambassador informed the Minister that a DG Tax official had sent a letter informing Parsons, the construction supervisor for the USG-funded Aceh road, that its operations were fully taxable under Indonesian law. Parsons estimates that if this opinion stands, its tax liability could exceed $10 million. Taxes on the construction portion of the road could exceed $40 million. For the U.S., this is straightforward--we can't pay $50 million in taxes for a $240 million project. This would be simply outrageous, the Ambassador stated, and if it stands, would provoke a fierce reaction in Congress. Land acquisition delays by the Government have already slowed the road project, and an adverse tax ruling could threaten the road's future. The Government's logic is faulty, the Ambassador continued--USAID and its partners have operated on a tax and duty-free basis since 1955 under a bilateral agreement. Someone needs to "stand back, look at the whole picture, and say 'no way,'" the Ambassador concluded. This is particularly important since the problem is spilling over to other USAID projects, also threatening them.

¶6. (SBU) Mulyani responded that the MOF's tax treatment on loans and grants for Aceh reconstruction "had not been based on a strong legal foundation." Our interpretation of the law "forces us to conclude that it may be a taxable activity." The problem is "logically solveable," Mulyani continued, and the MOF should not create unfair treatment for affected projects. The law is "very ambiguous and subject to interpretation," and a decree by the Minister of Finance or Director General for Taxation should be able to solve the problem. After conferring briefly with her aides, Mulyani concluded by noting "it can be solved. The tax will be born by the Government." (Comment: The Minister's comment appeared to be in the context of either a special regulation granting import duty and tax exemptions for Aceh reconstruction projects, or an amended 1995 regulation providing tax and duty exemptions for Government-related projects financed by grants and international loans, both of which provide narrower tax and duty exemptions than USAID's standard Strategic Grant Operating Agreements (SOAGs). As such, her comment may not be as reassuring as it sounds, particularly for USAID projects operating outside of Aceh. End Comment.)

Land Acquisition for the New Embassy Compound

¶7. (SBU) The Ambassador stressed the need for a response before the end of this month to the Department's renewed request for a determination of the value of MMS 3, and a confirmation of the value of MMS 4 - the two parcels of land the Embassy currently sits on which belong to the Government. The Minister said that the MOF is charged with managing Indonesian state assets, and that determining the cost should be relatively straightforward. However, a forthcoming Presidential Regulation issued under the 2004 State Treasury Law (Law 1/2004) establishes elaborate procedures for selling Government property, although she accepted the Ambassador's point that the law appears to make an exception for land that is to be used for offices of foreign countries. Nonetheless, in principle, settling on values for the two parcels "can be and should be done," she said. Mulyani also said she believed there would be no legal barriers to swapping the property for another.

¶8. (SBU) The Ambassador replied that the USG would be happy to consider the possibility of a land swap if that was preferable, but that we would still need a valuation of the properties before we could enter into such discussions. The Minister asked the Embassy staff to be in touch with Mr. Hadiyanto, the MOF's new Director General for State, and asked for assurances that the Governor of Jakarta's office is supportive of the Embassy's plan to re-build our Chancery on the existing property. The Ambassador noted that the Embassy has worked closely with the Governor's office on the NEC project and has received repeated statements of support, and agreed to seek a note from the Governor's Office, expressing its support.

Vice President Kalla, the Embassy's next-door neighbor, has also indicated he supports the project.

PASCOE